MEMORANDUM

**To: Board of Directors, North Coast Railroad Authority**

**From: Christopher Neary**

**Date: June 5, 2011**

**Re: Operating Agreement with SMART**

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## 1. Introduction:

The 1995 decision to purchase the NWP line from Southern Pacific was jointly made by the County of Marin, the Golden Gate Bridge Highway and Transportation District, and the NCRA. In this context a further decision was made to divide the ownership at Healdsburg with the NCRA owning North of Healdsburg and a newly created caretaker agency, Northwestern Pacific Railroad Authority, ("NWPRA") owning the South of Healdsburg. Because both agencies aspired to operate outside their assigned ownership territories reciprocal easements were exchanged, NCRA accepting a freight easement South of Healdsburg and NWPRA/SMART accepting a passenger easement North of Healdsburg.

The Easement to the NCRA provided that an Operating Agreement had to be developed before the NCRA assumed operating responsibilities from Southern Pacific's lessee of the line, California Northern Railroad. Between the date of purchase, April 30, 1996 and August 16, 1996 an agreement was negotiated and consummated between the NCRA and the NWPRA.

The 1996 Operating Agreement addressed the notion that the NWPRA would be a caretaker owner until the political imperative developed in Sonoma and Marin counties to create a new agency to develop transit operations on the corridor. Hence the agreement placed *all* of the corridor preservation costs upon the NCRA and indemnified the NWPRA from any of the typical responsibilities of ownership.

The notion that the NCRA would be responsible for all costs of ownership, including maintenance was grounded in the then existing realities that NCRA was receiving revenue from the operation of the line while the NWPRA was merely a caretaker agency.[1] Subsequently, the NWPRA transferred in 2003 its rights to the newly created SMART which seeks to establish transit service in harmony with the freight operations contemplated by the Freight Easement.

The 1996 Operating Agreement contemplated that when SMART undertook to provide transit service the agreement would be renegotiated to address the operating issues related to share use of the track. In 2009 the parties commenced negotiation of the new operating agreement to address the day to day

[1] This reality was significantly impacted by the 1998 FRA decision to close the railroad in recognition that deferred maintenance extending back to the late 1970's, particularly for the signal equipment, closed the line leaving the already underfunded NCRA with only unreliable grant funds to perform the contractually required maintenance requirement. To address this issue the NCRA sought funding for maintenance through the TCRP program and solicited through an RFP process a capitalized Operator to assume the maintenance requirements once the grant funds restored the signals and caused the lifting of EO 21. It should be emphasized that the assumption of the maintenance requirement by the Operator until SMART begins transit service represents a significant measure of consideration flowing to the NCRA in the Resurrection Agreement.

operational issues relating to shared use. The subject agreement represents the product of the negotiations.

Briefly summarized, this new Operating Agreement replaces the 1996 Agreement and a series of related agreements between the NCRA and the NWPRA. The 1996 agreement was necessarily vague as to the respective obligations of the parties upon operational issues leading to nearly impenetrable verbosity. This replacement agreement reconciles all of the existing agreements and addresses operating issues with specificity in a comparatively elegant directness.

This agreement is of some urgency for both agencies. For SMART the agreement establishes the parameters for the rights and obligations of the parties for construction of the transit facilities. This is of urgency to SMART because it is poised to issue bonds for the construction and to issue bidding documents for its public works project. It is of urgency to the NCRA because the finalization of this agreement is one of the condition precedents to the authorization of operations under Resurrection Agreement, such freight operations in readiness to commence directly.

The negotiations adopted a multitude of substantial compromises between the negotiators upon hundreds of separate but interlocking issues. The Resurrection Agreement contemplated our Operator's active participation in the negotiations recognizing that it would be operationally and financially impacted by specific operational compromises. Hence this was a three-way negotiation between the NCRA, its Operator and SMART. The agreement involved at times substantial participation of the staff of the agencies, their counsel and policy makers. The NCRA Board was consulted on a regular basis throughout the negotiations with the progress of negotiations documented for it in written reports at critical points in the negotiations.

Although the Resurrection Agreement extended to the NWP Co. the right of participating in the negotiation of this agreement, this agreement is an agreement between the NCRA and SMART. The contemplated amendment of the Resurrection Agreement, which amendment by necessity and through express condition required the completion of the negotiations of this agreement, will contractually assign to the Operator those provisions which otherwise would be the sole obligation of the NCRA absent any agreement with an Operator.

Due to the agreement's enshrinement of interlocking compromise upon specific operational issues, the substantial policy maker involvement for both agencies throughout the negotiations and the mutual urgency of both agencies this Agreement is presented to the respective boards for up or down consideration. The SMART negotiators have signed off on the agreement under consideration it being anticipated that the SMART Board of Directors will consider this agreement at its meeting on June 15.

## 2. Agreement Structure

Globally, this agreement does not fundamentally change the relationship between SMART and the NCRA. SMART retains control of the right-of-way by reason of its ownership, but subject to the NCRA Freight Easement. This agreement addresses the reality of imminent commencement of construction by SMART in the context of an operating freight railroad, and reconciles how transit and freight operations will co-exist.

The technical definitions used in this agreement are found at Exhibit 1 and are indicated in the body of the Agreement by capitalization.

Article II ( pp.2-3) of this agreement addresses operating rights between the parties.

Article III (p. 3) approves the NWP Co. as NCRA's operator fulfilling the conditions founded in the 1996 Agreement.

Article IV (pp. 3- 4) addresses and updates the maintenance requirements.

Article V (pp. 4-6) addresses Operations and Dispatching.

Article VI (pp. 6-10) addresses modifications and improvements.

Article VII (pp. 10-11) addresses specific operational issues implicit in the sharing relationship.

Article VIII (pp. 12-13) addresses Other Rights and Obligations relating to Property.

Article IX (pp.14-16) addresses the assignment of liability between the parties.

Article X (pp.16-17) sets forth the insurance requirements of the parties.

Article XII (pp.17-18) sets forth the representations and warranties of the parties.

Article XIII (page 18) establishes the notion that a permanent Coordination Committee will be established to react to specific issues as such issues arises.

Article XIV (pp 19-20) establishes arbitration as the vehicle for resolving any disputes in the future.

Article XV (pp. 20-21) establishes the term of the agreement.

Article XVI addresses miscellaneous matters.

## 3. Article II –Multi-Use Pathway and Operating Rights

The 1996 Operating Agreement authorized NCRA to conduct limited excursion service. Between the years 1996-1997 NCRA's franchisee conducted a successful excursion service mostly between Healdsburg and Willits. The Resurrection Agreement at Article VII (C) extends to the NCRA's operator the exclusive right to establish excursion service for two years after FRA certification. The new Operating Agreement defines the extent that such excursion service. The new agreement permits boarding at the Healdsburg Station reversing a prohibition contained in the 1996 Agreement which prohibition caused substantial operational constraints. Note that Section 7.08 contains a negotiated limitation upon institution of excursion service.

The new agreement also provides a structure for SMART approval of the installation of new sidings.

The new agreement also recognizes that SMART retains the sole right to design and construct Pathways on the Willits Segment should it choose to extend pathways north of Healdsburg such as to Cloverdale, a foreseeable SMART terminus within the term of this agreement. It should be noted that the current agreement recognizes that SMART's control of the design of a potential pathway on both NCRA easement and fee right of way operates to supersede NCRA's Trail Policy adopted in May 2010. In this regard the Final Environmental Impact Report to be considered by the NCRA Board late this month is affected, the negotiations of this new agreement having been finalized on Friday June 3rd. The NCRA Trails policy will not control the SMART design of its pathway. To the extent that the FEIR suggests otherwise, the provisions of the new operating agreement will govern, to the extent inconsistent with the NCRA Trails Policy. It was not perceived as a substantial issue so as to require redrafting of the FEIR, but it is important for the Board and the public to understand that that current agreement accommodates SMART's legitimate interest in retaining control over pathway design.

## 4. Article III - Approval of NWP co.

This new operating agreement recognizes SMART's approval of NCRA's operator.

The three-way negotiations provided a mechanism for coordinating the operating plans of SMART and the NCRA's operator. The parties employed a technical sub -committee through which the respective engineering collaboratively developed operating plans. Although this exposed issues of inquietude which had to be compromised through the separately tracked negotiation of the engineering staffs, the ultimate product is far superior to what would have been the alternative had NCRA merely introduced an operator to SMART leaving these issues to be confronted on a day-to-day basis.

## 5. Article IV - Maintenance

This new operating agreement perpetuates the notion that the NCRA will provide maintenance of the right of way until such time as SMART commences transit operations. The Resurrection Agreement provides that this substantial obligation will be assumed by NWP Co. it being recognized that the NCRA has insufficient funding to otherwise fulfill this obligation imposed upon it by the successive operating agreement s, and separately by the federal statutory residual common carrier obligation to maintain the line.

This contractual and statutory obligation has renewed significance for both SMART and the NCRA in that the FRA has lifted the Emergency Order 21 and shippers have the present right to demand that the railroad be maintained so as to permit freight operations in fulfillment of the residual common carrier obligations held by SMART and the NCRA. The de facto embargo necessitated by the interposition of EO-21 as to the NWP line was recognized by the Surface Transportation Board as being a temporary legal excuse for noncompliance with the common carrier obligation set forth in 49 U.S.C. §11101. (See *Michael H. Meyer, Trustee in Bankruptcy for the California Western Railroad,* Finance Docket # 34337, July 27, 2005) Poignantly, on the same day as the *California Western* decision the Surface Transportation Board elected to proceed with damage claims against a public entity which owned railroad right of way, but failed to meet its common carrier obligations. (See *Greenville County Economic Development Corporation,* Finance Docket # 34487, July 27, 2005) This illustrates that the lifting of E0-21 has the impact of bringing common carrier maintenance responsibilities to the fore. Hence, NCRA's assumption of maintenance responsibilities is of significance to SMART and the NWPCo's contractual assumption of these responsibilities is of significance to the NCRA, especially in the face of shippers demanding service on the line.

## 6. Article V - Operations and Dispatching

Early in the negotiations SMART identified the importance to it to control the line immediately, such control being exercised by the dispatching function. The 1996 Operating Agreement ambiguously provides that SMART would assume the dispatching function when it undertook to provide transit service notwithstanding this ambiguity this agreement places the dispatching function with SMART and defines the priority of operations.

It should be noted that as this agreement was being finalized SMART expressed concern with the description of the cumulative noise impacts in the FEIR. The NCRA does not believe that addendum is necessary in that the comment period has closed and further that NCRA acknowledges in the proposed resolution certifying the FEIR that noise impact of freight service by itself is a significant and unavoidable impact irrespective of transit service.

## 7. Article VI - Modifications and Improvements

This agreement provides the framework for either SMART or NCRA making improvements or modifications to the shared track facility, with particular emphasis upon operations conducted during the imminent SMART construction. Obviously SMART would prefer unlimited access during construction as any access limitations translate to potential construction cost increases, while the Operator would prefer no limitations upon service. This agreement reconciles these competing interests through compromise with each entity recognizing the important public interest served by each agency fulfilling their respective mandate. These provisions are particularly intricate in their detail corresponding to the relative importance of these issues for the parties.

## 8. Article VII - Other Rights and Obligations of the Parties

This Article addresses expansion of the shared track, the potential admission of third parties on the shared track, the impact of positive train control ( an automated collision safety feature) and SMART's assumption of limited cost in providing for Operator retrofitting.

## 9. Article VIII - Cost Sharing

This article refines the allocation of costs between the two agencies in substantial detail, somewhat in contrast to the broad and therefore inherently vague statements upon the issue in the 1996 Operating Agreement.

## 10. Article IX Indemnity

There is no substantial change from the 1996 Operating Agreement. This agreement however states the indemnity requirements with greater focus now that the operating plans of the two entities are more carefully defined and known to the other.

## 11. Article X - Insurance

This agreement establishes the insurance requirements. Not surprisingly this agreement reflects the insurance currently maintained by NWP Co. in that NWP Co. has already commenced training operations on the Easement Premises. The amendment to the Resurrection Agreement will require NWP co. to maintain NCRA's liability insurance obligations. The amount of liability insurance was determined by a subcommittee of the parties inventorying liability limits for similarly situated freight operations. Although the insurance requirement is reduced from that established in the 1996 Agreement, the 1996 requirement was rooted in a complex requirement relating to the now expired General Indemnity Agreement negotiated between Southern Pacific in its option to the Golden Gate Bridge and Highway Transportation District and in its separate lease of the Lombard to Willits Segment to California Northern Railroad which was in place between 1991 and 1996.

## 12. Article XI - Representation and Warranties

This agreement reflects standard warranties of due authorization and execution.

## 13. Article XII Coordination Committee

In that complex issues between the parties were reconciled by these negotiations it is reasonable to expect that inevitable issues relating to shared use of the line in the future will be successfully be addressed by a Coordination Committee established for this purpose.

## 14. Article XIII Arbitration

In the event that issues arising in the future are not successfully resolved by the Coordination Committee, this agreement provides for and governs arbitration. Noteworthy is the employment of the arbitration style employed by Major League Baseball where the arbitrator chooses between two arbitration positions. Hence if a player and ballclub are arbitrating salary the arbitrator is required to accept one of the two positions and to not split the difference. This operates to facilitate compromise and restrain the parties from whimsically resorting to arbitration by raising the stakes to the point that there is a 50/50 chance that the position of one's interlocutor will be accepted in its entirety. NCRA and NWP Co resisted this provision in that while it might adapt itself well to choosing between two defined salary positions between that of say a shortstop and his team, it may be unwieldy in the administration of a shared railroad track. On the other hand, NCRA's interest in avoiding costly arbitration proceedings is furthered by this provision which encourages resolution at the Coordination Committee level. In any event, this provision represents an integrated compromise.

## 16. Article XV - Term and Termination

The term of this agreement by necessity must be for a long term because the agreement recognizes and contemplates substantial capital investments by the parties. The term is forty (40) years with three successive options of ten (10) years each leading to the possibility that this agreement will be in place for seventy (70) years, without prejudice to the ability of the parties to amend the agreement.

The termination provision was a particular focus for the NCRA in that this agreement merely updates and amends the 1996 Operating Agreement, NCRA's right of operation being grounded in its property right pursuant to the Freight Easement. As with other provisions of this agreement the absolute objectives of the NCRA required compromise. The compromise reflected in this agreement, which in the opinion of the undersigned is adequate to the NCRA's fundamental need for the supremacy of the Freight Easement, is that a violation of the agreement would not be construed as a forfeiture of freight easement rights, as reconciled with the fundamental interest of SMART that NCRA's rights to operations while not being sourced in the agreement, are in compliance with the negotiated terms of the agreement. This is to say that in the event that NCRA is adjudicated as not being in compliance with this agreement, its operation rights cease, but such rights are capable of being restored under the freight easement if NCRA brings itself into compliance.

## Article XVI Miscellaneous Provisions

The Board should review these provisions. Although predominantly boilerplate, there are some significant provisions. Particularly Section 16.06 contains a release of all known and unknown claims by both agencies against the other. While such a provision is common, it does bear special mention.

SMART possesses some financial claims against NCRA which are derivative from claims asserted previously by NWPRA which are related to what we considered to ambiguous provisions in the 1996 agreement relating to brush clearance outside the defined limits of the "track," such claims being carried on our books as a contingent liability.

NCRA possesses unasserted claims against SMART for the expense by NCRA for repair of the Blackpoint Bridge in response to Coast Guard demands which extended beyond normalized maintenance and addressed deferred conditions in existence at the time of the 1996 purchase which was outside NCRA's responsibility. While these claims were never asserted directly against SMART, and the statute of limitations may have expired, the NCRA claims could be asserted by way of offset had SMART ever asserted financial claims against the NCRA.

By this agreement any and all claims are abandoned by the parties. The one exception relates to SMART's prior contractual obligation to cancel the note and reconvey the deed of trust on the Ukiah Depot with an approximate principal balance of $180,000, which balance was to be forgiven by SMART by reason of the 2004 agreement by which the rail corridor was transferred by NWPRA to

SMART. There was insufficient time for SMART to process the reconveyance so it is addressed as a specific exception from the operation of the release.

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